United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

74-1069

UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Appellee,

v.

GLEN-ARDEN COMMODITIES, INC., MILBANK TRADING CO., INC., ALBERT J. DEEB, JOSEPH LAMONICA, CHARLES LOFFMAN, PHILIP WEINSTEIN, DAVID LOSEY, PATRICIA GALIOTO, DAVID LOEB,

Defendants-Appellants.

On Appeal from the United States District Court for the Eastern District of New York

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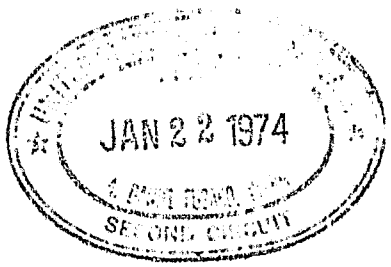
ANSWERING BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE



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GLEN-ARDEN COMMODITIES, INC., MILBANK TRADING CO., INC., ALBERT J. DEEB, JOSEPH LAMONICA, CHARLES LOFFMAN, PHILIP WEINSTEIN, DAVID LOSEY, PATRICIA GALIOTO, DAVID LOEB,

Defendants-Appellants.

On Appeal from the United States District Court for the Eastern District of New York

ANSWERING BRIEF OF THE SECURITIES AND EXCHANGE COMMISSION, APPELLEE

COUNTERSTATEMENT OF ISSUE PRESENTED

Did the district court abuse its discretion in preliminarily enjoining defendants from selling or offering for sale securities in the form of investments in scotch whisky in violation of the registration and antifraud provisions of the Securities Act of 1933 and of the antifraud provisions of the Securities Exchange Act of 1934, where the evidence before the district court showed that:

(1) defendants were advertising and selling an investment package consisting of services and wares which would purportedly enable investors to double or triple their money;

(2) investors were led to believe by defendants that they did not have to perform any essential functions in realizing the profits;

(3) the investors were generally unknowledgeable about the scotch whisky industry; and

(4) defendants failed to advise investors, inter alia, of the substantial risks involved in the enterprise and of the grossly inflated prices at which they were purchasing.

This brief deals with the substantive merits of the preliminary injunctive relief issued against defendants. In addition, defendants raise both on this appeal and in their companion petition for a writ of mandamus a number of procedural challenges to the preliminary relief. We respectfully refer the Court to the Commission's answering brief (pp. 1-12) to the petition for a writ of mandamus for our responses to these procedural arguments. Finally, we suggest, as we did with respect to the petition for mandamus, 1/ that this appeal from the district court's award of temporary relief has been made moot by the district court's award of a preliminary injunction on January 18, 1974. Defendants, we suggest, should file a notice of appeal from that preliminary injunction. The Commission, for its part, is most desirous that expedited treatment be afforded any such appeal.

1/ See Commission's answering brief to petition for mandamus, pp. 7-8.

PRELIMINARY STATEMENT

This appeal was filed by every defendant from "each and every part of the injunctive orders . . . dated November 16, 1973, November 23, 1973, December 1, 1973, and December 18, 1973" issued by the court below. Each of those orders was styled "Temporary Restraining Order" and superseded the prior order.[2/] The last order, dated December 18, 1973, stated that it would continue in effect pending determination of the motion for preliminary injunctive relief made by plaintiff-appellee Securities and Exchange Commission ("Commission").

The district court on January 17, 1974, issued an opinion disposing of the Commission's motion for a preliminary injunction, which constituted its findings of fact and conclusions of law. On the following day, the court issued an order of preliminary injunction restraining defendants from further violations of Sections 5 and 17(a) of the Securities Act of 1933 ("Securities Act"), 15 U.S.C. 77e and 77q(a), and Section 10(b) of the Securities Exchange Act of 1934 ("Securities Exchange Act"), 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 CFR 240.10b-5.

2/ All of the defendants except Philip Weinstein, on January 10, 1974, filed a petition for a writ of mandamus to this Court requesting that the Court vacate these orders and forbid the district court from entering similar orders.

The court below in its opinion concluded from the evidence presented by the Commission that the "investment package" offered by defendants was a "security" within the ambit of Section 2(1) of the Securities Act, 15 U.S.C. 77b(1). It found that salesmen employed by defendants were instructed to induce prospective customers to invest in their products by making the following assertions:

> "(1) Milbank would utilize its expertise in selecting the type and quality of Scotch whisky and casks to be purchased;
>
> (2) Customers could call Milbank and obtain current information about the Scotch whisky market;
>
> (3) Milbank would provide the cooperage[3/] of the whisky;
>
> (4) Milbank would provide two insurance policies to protect the investments;
>
> (5) When the customers wished to sell their whisky, Milbank would assist them in making a sale at the current pricing schedule, charging no fee or commission;
>
> (6) Milbank would handle all administrative details of the transaction; and
>
> (7) Customers could expect a doubling of the value of their investment within three to four years and further increments after that." (Op. pp. 9-10). 4/

3/ "Cooperage" is the deposit of money made to obtain a cask for whisky (footnote added).

4/ References to the district court's opinion, copies of which are appended to the Commission's Answer to the Petition for a Writ of Mandamus, will be preceded by "Op."

Although defendants were found to be transferring title to particular casks of whisky, the district court stated that the testimony of the investors established that the investors were not knowledgeable about the scotch whisky industry and relied solely on the expertise of defendants for the management of their investments (Op. p. 11). In light of the evidence, the court rejected as untenable defendants' contention that they were merely selling gallons of raw unblended whisky that could be consumed, sold or dealt with as a purchaser saw fit (Op. p. 12). Defendants' solicitation, its advertisements, its sales, and the statements of its salesmen were found by the court to have emphasized that the purchasers were making an investment (ibid.). Indeed, investors would not have purchased had they not been furnished cooperage and insurance and had they not been promised defendants' assistance in the liquidation of their investments (ibid.).

The district court not only concluded that defendants were selling securities, but also that they had engaged in a pervasive scheme to defraud the public. Even their mode of training their "salesmen" was found deficient. Essentially, salesmen were recruited who were familiar "with neither the Scotch whisky business nor investment practices." (Op. p. 8). The salesmen were provided with a "canned" sales pitch along with sales literature directed to potential customers solicited through mass merchandising techniques (ibid.).

The training of salesmen consisted of meetings at which defendants or their employees provided certain data on the investment package and "the profits which could be anticipated." (Op. pp. 8-9). The court further found that the salesmen were instructed to make "quick" presentations (Op. p. 10).

The district court stated that it was satisfied from the record that there was sufficient basis for entry of an order of preliminary injunction enjoining the defendants from further violations of the securities laws. The court concluded:

> "The S.E.C. has clearly met its burden of showing probable success on the merits and that there is a likelihood of continued violations of the registration and anti-fraud provisions of the securities laws." (Op. p. 14).

COUNTERSTATEMENT OF THE CASE

This action arises out of the marketing by defendants of a form of investment to the public which has recently become a popular "get rich scheme" aimed at those who are unfamiliar or frustrated with the more conventional modes of investment in securities. The evidence adduced at the hearing below demonstrates that the whisky investments which defendants were promoting were properly found to be securities as that term is defined in the federal securities laws. Essentially, the scheme was to sell to persons unknowledgeable in the scotch whisky industry a package consisting of specific casks of whisky plus essential services without which the whisky would be

worthless to the investor. The evidence shows that investors put up their money not to secure casks of whisky but in an enterprise which was virtually guaranteed to "double their money" in four years.

Defendants' Enterprise[5/]

Through the individual defendants' managerial and marketing efforts, the defendant companies along with their agents[6/] have been engaged since mid-1967 in the widespread promotion and sale of scotch whisky investments to members of the public in this country. Although the defendants claim in this lawsuit that they sell nothing more than "casks of scotch whisky" (Br. 49), their sales literature describes their product as, among other things, "Scotch Whisky an intriguing new way to invest" (Exh. 34, 49, 69, 56j), "a very successful method of diversified investments" (Exh. 96), and "a possible answer for Capital Gains at maturity" (Exh. 26). Through inducements such as these and through extensive advertising campaigns in the newspapers and through the mails with follow-ups by individual salesmen, defendants have managed to sell to well over 800 investors over $3,000,000 in scotch whisky investments (Tr. 48-49, 136-137, 395, 573-574, 611, 622-623; Exhs. 57a-57c, 80).

Milbank supplies Glen-Arden on demand with all of its whisky needs at an agreed price. (Exh. 59, pp. 63-65). Milbank obtains its inventory through its buyer, defendant Lamonica (Tr. 500-503, 508-509, 523, 617), who buys it from Scotch Exchange Limited in the Bahamas

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5/ References to the trial transcript will be preceded by "Tr." while references to exhibits admitted at trial will be preceded by "Exh."

6/ Defendant Milbank Trading Co., Inc. ("Milbank"), has been selling its scotch whisky investments to the public since 1967 (Tr. 600-601, 611; Exhs. 57c, 80, 93).

(Tr. 508-509; Exh. 80), of which he and defendant Weinstein are directors and stockholders (Tr. 618-619; Exh. 78). Scotch Exchange Limited in turn obtains its interests from other intermediaries directly or indirectly from Scotland (Tr. 619). Defendant Weinstein is the president and controlling stockholder of Milbank as well as of Stock Exchange Limited (Tr. 494, 616; Exh. 93). Milbank in turn is closely affiliated with Glen-Arden to the point of being virtually one with it. Milbank had started offering to the public scotch whisky interests in 1967. (Tr. 600-601, 611; Exhs. 57c, 80, 93.) Actively involved in its operations and directions were defendants Weinstein, Galioto, Lamonica and Deeb who was president. Deeb while still president of Milbank founded Glen-Arden in August 1970 and was president of both companies until October 1970. (Tr. 598; Exh. 93.) He subsequently continued, as Galioto testified, to render managerial assistance to Milbank because "he would remember what was going on . . . and I had to make sure I was doing it correctly." (Tr. 512.) The defendants David Losey ("Losey"), David Loeb ("Loeb") and Charles Loffman ("Loffman"), the latter of whom is Deeb's brother-in-law, are Glen-Arden sales representatives and in Losey's and Loeb's cases hold supervisory positions as well (Tr. 110-112, 136-137, 173, 223, 225-226, 267-268, 277, 327, 329, 333, 337-338, 347-350, 605-606, 673-675, 746, 790; Exhs. 29, 33, 47, 59 (pages 52-53)).

In addition to supplying Glen-Arden with all of its scotch whisky needs, Milbank processes all of Glen-Arden's paper work, refers customers to Glen-Arden and grants Glen-Arden exclusive sales rights in certain areas (Tr. 120, 416-418, 420, 444-415, 500-502, 532-533, 536-538, 541-542, 546, 562-563, 589, 590, 611, 647, 755; Exh. 59, pp. 63-65, 73, 75, 77-79). Milbank is

also obligated to pay annually all insurance and warehousing charges arising from the interests in scotch whisky sold to members of the public by Glen-Arden. (Tr. 120, 416-418, 420, 444-445, 500-506, 532-533, 536-538, 541-547, 554, 562-563, 577-579, 601, 611, 642, 644, 647; Exhs. 59 (pages 63-65, 75, 77-79), 78, 79 (pages 4, 50--1971 ledger; 4, 50--1972 ledger; 50--1973 ledger), 83, 84, 85, 88.) On the other hand, Glen-Arden has assumed Milbank's obligation by rendering resale assistance to former customers of Milbank at no charge (Tr. 505-506, 511-512, 602-605; Exh. 59 (pages 63-65, 92)). Finally, defendants Glen-Arden and Deeb portray themselves as virtually one and the same with Milbank. Although as noted, Glen-Arden was not incorporated until 1970, in a report distributed to sale representatives by Glen-Arden it was stated Glen-Arden was started in 1968 and "is closely affiliated with . . . Milbank . . . ." (Exhs. 57(a), 57(b).) Deeb himself stated in May 1973 that "this sale of Grain Whisky . . . was introduced into this country by us four years ago . . ." (emphasis added) (Exh. 96). Glen-Arden moreover advertises its wares by referring to how "Milbank of N. Y. customers . . . have realized a profit . . ." (Tr. 416-518, 420, 444-445; Exhs. 26, 57a-c, 96). Glen-Arden Commodities, Inc. ("Glen-Arden"), which only recently adopted that name (Exh. 24), was formerly known as Milbank Trading Co. of Conn., Inc.

Sales Practices

Milbank, as indicated above (p. 7), sells to Glen-Arden, which then sells the defendants' investments in scotch whisky to the public through sales representatives, who are supplied by Glen-Arden with literature and the names of prospective customers. (Tr. 102-103, 137, 218-19, 289, 684-685, 724; Exhs. 48, 96). Checks for the

investments are made payable by investors to Glen-Arden which, in turn, furnishes the investor with the appropriate documents. (Tr. 102-103, 218-219, 685; Exhs. 37, 38, 40, 41, 42, 43). In many instances, the documentation is delivered to investors by the sales representatives for the company (Tr. 77, 144). The sales representatives are initially taught how to sell by the company; they attend periodic sales meetings concerning selling techniques sponsored by the company and at the company's expense; they receive sample sales presentations, sales aids and periodic market information from the company; they receive remuneration from Glen-Arden; they receive W-2 forms at the end of the year from Glen-Arden; they are given business cards bearing the company's name and their name as a company representative; they sign receipts on behalf of the company; they transact business on behalf of and inuring to the benefit of the company, and they hold themselves out and are so held out by the company as representatives and agents of the company. (Tr. 102-103, 136-143, 146, 218-219, 267-272, 274, 276-280, 288-289, 296-297, 631, 369-640, 655, 684-685, 722-725, 796-797; Exhs. 1, 3, 4, 5, 6, 7, 8, 9, 10, 12, 12a, 13, 28, 29, 30, 31, 32, 33, 34, 37 48, 54, 55, 56a, 57a, 57b, 59 (pages 21, 31-39, 51-55, 58, 69, 82-87, 96).)

The selling instructions given company sales representatives are to provide the customer with as little concrete information as possible. (Tr. 276-278; Exh. 59 (page 30)). Salesmen are also advised to make an eight to ten minute oral sales presentation in lieu of leaving printed materials with customers. (Tr. 274, 276-278,

327, 780-781; Exh. 59 (pages 30; 35-39, 49, 82).)[7]

Promises--Promises

Despite defendants' argument that they sell only casks of whisky,[8] the evidence shows that at no time do investors contemplate

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7/ As a result of the testimony concerning defendants' sales practices, the district court found the following:

> "Essentially, their mode of operation was to recruit salesmen familiar with neither the Scotch whisky business nor investment practices, provide "these men with a 'canned' sales pitch along with sales literature and direct them to potential customers solicited through mass merchandising techniques such as newspaper advertisements and the indiscriminate use of mailing lists.
>
> "The training of the salesmen consisted of meetings at which defendants or their employees provided data on the price of Scotch whisky, the cost of insurance and cooperage and the profits which could be anticipated from an investment in Scotch whisky warehouse receipts. Specifically, there is evidence that defendants Albert J. Deeb, Charles Loffman, David Loeb and David Losey appeared at various sales meetings during which the salesmen were instructed [concerning their presentations to] . . . prospective customers . . . . [S]alesmen were encouraged to make 'quick' presentations using the 'support' data supplied by the defendants. It is noteworthy that the salesmen were specifically instructed not to leave this data with the customers. The testimony of the customers confirms that after the sales presentation no data were left with them. The customers were given Milbank sales literature and the documents of title only." (Op. pp. 8; 9, 10).

8/ Defendants furnish a number of documents to the investors who purchase from them. The documents include an original sales order which sets out the quantity of whisky purchased and the price paid therefor (Exhs. 12, 12a, 32, 33, 37, 43); a confirmation evidencing the number of barrels of whisky purchased, the amount of whisky contained in each barrel and the registration number for each barrel (Exhs. 11a, 12d, 32, 33); a copy of the warehousekeeper's records (Exhs. 11c, 12g, 12h, 43); and transfer certificates issued by the distillery confirming transfer and registration of ownership to the purchasing investor (Exhs. 11b, 12e, 12f, 32, 33, 41). The investors also receive two insurance policies insuring generally against error or fraud by the warehousekeeper (Exhs. 112, 11e, 12i, 12j, 12k, 12l, 32, 33, 40, 48); and a form ordering the warehousekeeper to transfer ownership, which form includes the warranty of the signature of the new owner (Exhs. 33, 43, 12b, 12c, 32).

taking physical possession of the whisky (Tr. 52-53, 386-387, 625). Rather, investors buy the defendants' scotch whisky interests based upon representations by the defendants that the investor's only obligation will be to furnish the defendants with his money and that they, the defendants, will perform all the necessary services to insure that the investor realizes a profit (Tr. 50-51, 138-139, 212-213, 215-216, 280, 333, 572, 574, 576-578). Thus, one Glen-Arden sample sales presentation reads, "[t]he price per gallon is $2.80--that is all you pay" (emphasis added) (Exh. 96), and another company guide entitled the "Milbank Program" (Exhs. 7, 54) enumerates a long list of services performed by the company at no additional charge to the investor. The defendants, as stated in full in the Milbank Program and duplicated elsewhere in other company literature and orally by company employees, promise to do the following: (a) arrange for and thereafter annually pay for certain insurance policies included in the investment package (Tr. 50, 138-39, 212-213, 215-216, 280, 387-88, 414-15, 572-74, 581-82, Exh. 5, 7, 54, 56i, 56j); (b) arrange for and thereafter annually pay for all warehousing charges (Tr. 50, 139, 198, 215, 218-219, 280, 384-385, 414-415, 572-574, 581-582; Exhs. 5, 7, 54, 56 56j); (c) arrange for and pay for cooperage (Tr. 50, 139, 198, 215, 218-219, 280, 384-385, 572-574, 581-582; Exhs. 5, 7, 54, 56, 56j); (d) select the type and quality of casks to be purchased (Tr. 50, 138-139; Exhs. 5, 49); (e) select the

type and quality of scotch whisky to be purchased (Tr. 50, 138-139, 141, 142, 216-17, 572-73, 600-01, Exh. 5, 7, 54, 56, 56j); (f) periodically provide price and market information on the value of the investment (Tr. 51-53, 142, 213, 311-16, 319, 326-27, 344-45, 388, 395, 573-74, Exh. 5, 7, 54, 56, 56j); (g) advise whether or not to hold or sell the investment, as well as whether or not to enter into one of a number of exchange transactions or any combination of the above (Tr. 51-52, 140, Exh. 5, 7, 54, 56j); (h) perform throughout the investment period all paperwork and absorb all administrative expenses resulting from the investment (Tr. 50, 52, 198, 215-16, 600-01 Exh. 5, 7, 54); (i) and either sell or themselves repurchase the investment (Tr. 51-52, 118-20, 140, 145-49, 159, 165, 207, 212-13, 216, 277-80, 283, 311-13, 331, 344-45, 386-87, 402-03, 593-94; Exhs. 5, 7, 54, 56g, 59 (pages 38-39, 58-59, 92)).

The defendants not only guarantee the essential services, they promise results. As the record amply demonstrates, the defendants have promised prospective investors that through purchase of defendants' investment package the investors will double their money in four years, triple it in six years and quadruple it in eight years (Tr. 128, 279-279a, 329, 344, 388). Investors are assured that an investment in interests in scotch whisky is riskless except for the amount of profit to be made (whether a 50% profit or 100% profit). Some of the defendants' promises are:

"that an investment in SCOTCH WHISKY would double within three to four years and that 'SCOTCH enhances in value day by day." (Emphasis added.) (Exh. 65, p. 2.)

"that Milbank Trading Company would be in a position to make certain that we'd never lose anything on the investment." (Tr. 386.)

"We could expect a return of a minimum of 90 to 100% of our original investment at the end of four years." (Tr. 388.)

"that his company [Glen-Arden] would insure us a minimum profit over a four-year period of 58 per cent." (Tr. 212.)

"that Milbank [Glen-Arden] would provide a market for the Scotch--guaranteed we'd have no problem reselling." (Tr. 212-13.)

"you could build up an annuity by buying barrels every year, say for four years straight, and then at the end of the fifth year, you could trade two for one, and at the sixth year you could trade again, two for one, and so forth, you pyramid your barrels every four years." (Tr. 279-279a).

That the defendants have also promised to repurchase the whisky or to arrange its repurchase 9/ from investors is amply demonstrated in in the record. Thus, three different investors testified as follows:

". . . Mr. Loeb told me I bought the best whisky that could be bought and gave me some other sales spiel and I understood him to say if I was displeased--unhappy with the purchase--that they would repurchase the whisky" (Tr. 111-12.)

* * *

". . . That Milbank Trading would at any time we desired either purchase whatever scotch whisky we bought at not less than our original purchase price or . . . at

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9/ Defendant Deeb testified as follows:

"They have to hold it for four years, at which time they will have a price offer from brokers for it, and we would assist in finding the brokers sending the brokers names to them at that time to help them." (Tr. 780; see also Exh. 92.)

> maturity . . . trade this whisky in for twice the quantity of new whisky, [or] . . . they would act as our representatives in selling the whisky and obtaining the proceeds. . . ." (Tr. 387.)

* * *

> "He made me an offer at that time of $3.10 for my 1968, and $2.90 for my 1969. But essentially, though, the gist of his call was, hold it. . . . [i]t's going to be worth more. . . ." (Tr. 594.) 10/

Investors were not buying scotch whisky.

The investors purchasing these defendants' interests in scotch whisky, as the record shows, are generally unknowledgeable about the nature of the investment; the manner in which raw scotch is produced, aged or blended; and the general manner in which the scotch industry is financed and generally operated. (Tr. 48, 136-37, 211, 570). Four of the investor-witnesses testified that they first learned of such investments from the defendants and/or their agents (Tr. 48, 136-137,

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10/ Other investors testified to the following representations:

> ". . . [the Milbank salesman] indicated to me that there was a working arrangement between Milbank and the Bank in the Bahamas, which was, in effect, a financial arrangement between the two of them.
>
> "he also indicated to me that part of their arrangement was for bottling purposes, that Milbank intended to bottle their own liquor at the expiration of four years, under their own brand name. . . . (emphasis added)
>
> "He indicated to me that--that the bank in the Bahamas would re-purchase my scotch whisky, or Milbank would repurchase it. One or the other." (Tr. 413-14).

* * *

> ". . . at the end of the four year period that he [Glen-Arden] would get bids from distillers on my scotch and normally I could expect to get twice my original investment." (Tr. 345)

211, 570). Two of them infrequently engaged in stock transactions (Tr. 48, 136) and had never speculated in any commodity (Tr. 48, 136).

The record establishes that the investors purchased the package of managerial services offered in connection with the scotch whisky. Typical of the investors' testimony during the hearing was:

a) Haynes

"Q Sir, assuming that you had known when you purchased your investment in scotch whisky that Milbank would not have handled the resale, would you still have made the purchase?

A No.

Q Assuming you had known when you made the purchase that the warehousing was not included in the package being offered, would you have made the purchase?

A No.

Q Assuming you had known that the storage or cooperage was not included in the package, would you have made the purchase?

A No." (Tr. 120.)

b) Valli

"Q Finally, sir, as a hypothetical, if you had to purchase the insurance, the warehousing, the casks, on your own, would you have purchased the Scotch?

A No, sir." (Tr. 245.)

The evidence shows that performance of these essential managerial services by the defendants determine the success or failure of the investment. Thus, for example, the investor witnesses repeatedly testified that they had contacted the defendants and requested the promised sale or repurchase, that the defendants had refused and/or became

"unavailable" and that consequently they continued to hold the investment not knowing what to do. (Tr. 110, 114-117, 147-149, 203, 223-226, 282, 342, 416-426, 443-447, 476, 479-480, 536-538, 570-580, 582-583; Exhs. 14, 15, 16, 35, 47, 55, 86, 87, 88, 89, 90, 91).

The Fraudulent Practices

1. Misrepresentations concerning profitability of investment. The defendants and their agents, as has been previously discussed (pp. 13 - 15, supra), made promises to prospective investors concerning whisky investments doubling in value in four years, tripling in six and quadrupling in eight. Similarly, the defendants portrayed investments in interests in scotch whisky as "enhancing in value day by day" (Ex. 65, page 2) because "as that Scotch was maturing in age--it was also growing steadily in value" (Ex. 56, page 2), inasmuch as "the unchangeable law of Scotch is that older Scotch is worth more than younger Scotch" (Ex. 56, page 7). The evidence presented to the district court compelled the conclusion that the district court reached on this particular point (Op. p. 11, n. 3):

> "There is strong evidence that the value of whisky is determined by laws of supply and demand and that age alone does not determine its price."

Significantly, investors were not told that there was a substantial surplus of production of grain whisky in the late 1960's which had severely depressed grain whisky prices (Tr. 117, 133, 150, 183-185, 186-190, 216, 220-223, 233-234, 239, 243-245, 425-426, 447-448, 574-580; Exhs. 59 (page 38), 91).

At the heart of the fraud perpetrated by these defendants was their failure to inform prospective investors that Milbank and Glen-Arden have charged and do charge for scotch whisky prices which are considerably in excess of the prices charged by other brokers. Thus, for instance, while Glen-Arden during early 1972 charged $2.80 per unit (Ex. 28), similar investments were available elsewhere at prices ranging between $1.00 and $1.50. (Tr. 131, 183-84, 188-90, 220-23, 234, 239, 244-45, 425-26, 447-48, 574-80; Exh. 14, 46, 59 (pages 65-67, 70, 73-75, 91.)) Indeed, the excessive price charged by Glen-Arden caused Robert Taddonio, defendant Deeb's partner, sales manager and friend of 25 years, to terminate his relationship with the company.[11/] Taddonio testified that he had obtained a cheaper supplier, but that Deeb insisted on continuing to purchase from Milbank at an inflated price. As Taddonio explained, "[the lower price would have] allow[ed] us [Glen-Arden] to drop our selling price to a point where we would be competitive, and give our clients a better opportunity to make a profit on their investment." (Exh. 59, pages 6-9, 16-20, 22-23, 65-68, 70, 73-76, 86, 91.)

11/ See Tr. 619-621; Exhs. 55, 59 (pages 65-68).

Because of the inflated prices the defendants charge, their investors are not able to realize even their initial $2.60 or $2.80,[12] much less a profit (absent those exceptional instances where defendants fulfill their initial promise and repurchase the investments either directly or through affiliates). According to Deeb's testimony, 1968 and 1969 investments in interests in scotch whisky are now worth approximately $2.00 (Tr. 789).

2. Misrepresentations concerning defendants' expertise. Both Milbank and Glen-Arden have held themselves out as providing impartial expert guidance and consulting services to investors concerning such things as current prices, market conditions, timing of investment decisions and the type and quality of scotch investments. (Tr. 53, 95, 573; Exh. 5, 34, 49, 56, 56j). Typical of the oral advice the defendants have offered are defendant Loeb's representations to Haynes that he had been sold "the best whisky that could be bought" (Tr. 111-112, 141), while illustrative of the defendants' printed representations are the following excerpts taken from Glen-Arden's 1971 sales literature:[13]

> ". . . As specialists, trading only in Scotch Whisky, Milbank Trading has developed a simplified technique for cutting through the entangling snares of endless red-tape, eliminating confusing and complicated procedures. As a Milbank client, you will be able to take full advantage of the opportunities afforded by investing in Scotch Whisky.

12/ The defendants raised the price of the scotch whisky investments to the public from $2.60 to $2.80 per unit in early January 1972 (Tr. 144, 146, 212; Ex. 28).

13/ Glen-Arden was then known as Milbank Trading Co. of Conn., Inc. In April 1973 the company changed in name to Glen-Arden Commodities, Inc. (Exh. 24).

> "It is our aim and interest to do whatever we can to help obtain for our clients the best possible profit with the least amount of risk. Therefore, we recommend the purchase of Grain whisky rather than the volatile malt." (Ex. 56j, page 8; underlining added.)

The impression of disinterested expertise sought to be given by defendants is false and misleading. For one, the officers and agents of both Milbank and Glen-Arden do not possess special expertise in scotch whisky. For example, defendant Deeb, the president of Glen-Arden, has testified that he is not an expert and that as of February 1973 he had only made one trip to Great Britain to learn about the industry(Tr. 605-06, 608, 610-11). In addition, neither Milbank nor Glen-Arden nor their respective agents have provided investors with the promised accurate market information (Tr. 117, 146-147, 213, 388). Indeed, the market information that is supplied is itself misleading and false, as was previously described with regard to the defendants' profit representations.[14/]

With regard to the "impartial expert advice" offered, to wit, that grain is better than the "volatile malt" (Exhs. 56j (p. 8)), of note is the fact that the defendants until recently sold only grain whisky; their recommendation that investors purchase grain was obviously self-interested (Tr. 95, 142-143, 573; Exhs. 59 (pages 71-72),

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14/ In addition, the defendants have also falsely advised investors of such things as shortages in production and crop failures. Typical for instance were their representations that there had been corn crop and barley crop failures--when there had not been--and that there were only buyers and no sellers (Tr. 456-488; Exh. 4, 8, 50, 51, 52, 56, 63, 38, 70).

69). Indeed, investors have not been sold the best whisky that could be bought in that investments in malt have produced better returns and have been more stable than grain investments (Tr. 609; Exhs. 46, 59 (page 38)). Defendant Deeb has apparently also come to the same realization inasmuch as he now sells malt. (Exh. 24, 44). When asked during the evidentiary hearing whether grain was better than malt, he replied, "Possibly when it was sold in '68 or '69 but then malt whisky improved. It would be silly to say it . . ." (Tr. 609). Perhaps Deeb, however, forgot that as recently as late 1971 he authorized the distribution of a pamphlet recommending "Grain whisky rather than the volatile malt." (Emphasis added.) (Exh. 56j (page 8); Tr. 609; Exhs. 24, 44, 56i).[15/]

3. Misrepresentations concerning the marketability of the investment. The defendants have led investors to believe that there is a scotch whisky market akin to the over-the-counter securities market for unlisted securities where public sales can be quickly and easily effectuated at broadly disseminated prices. Specifically, many investors are falsely told they can follow the scotch whisky market quotations

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15/ The "impartial expert advice" Glen-Arden gives to its investors who wish to sell most frequently is to exchange or hold and not to sell. Thus, investors who have requested that their holdings be sold have received advice that they should continue to hold (Tr. 116-17, 133, 147-50, 183-85, 188-90, 203, 220-26, 233-34, 239, 243-45, 282, 342, 416-26, 443-48, 476, 574-80, 582-83, 594-95, 641, 692-93, 766-89; Exhs. 47, 91). For instance, James Suthann was advised when he telephoned to sell that he should "hold it . . . . It's going to be worth more, and what you should be doing is getting rid of one and buying more like '71 and '72 Scotch." (Tr. 594). This advice undoubtedly stems from the fact that Glen-Arden would be unable to resell the investments without itself taking a loss.

in the London Financial Times. (Tr. 142, 148-149, 212-216, 237, 311, 314-316, 319-321, 326-327, 331, 344-345, 386, 460, 572-574, 577; Exh. 59 (pages 71-74, 80, 94-95); Exhs. 4, 5, 8, 24, 26, 27, 31, 33, 34, 49, 50, 51, 56, 69, 95). However, those investors, for instance, who seek to follow the "scotch whisky market" quotations in the London Financial Times find, as did Eugene Lorenz and Robert Valli, that the defendants' representations concerning the publication of such information are false inasmuch as no such quotations are published (Tr. 142, 213-215, 237, 694-695; Exhs. 4, 6). Investors are not told that in fact there is no organized scotch whisky market (Tr. 184, 214, 216, 695; Exh. 59 (pages 76-77) and that when the major distilleries do occasionally buy additional quantities of mature scotch grain whisky, they do not buy the small investor's one or two barrels but instead make large cost-saving bulk purchases (Tr. 449-450, 595).[16/]

16/ Indeed, investors desirous of selling their whisky interests through others besides these defendants have found that there simply is no way they can liquidate their holdings (Tr. 444-447, 449-450, 579-580). Thus, for example, Herbert Sorscher, after being repeatedly "put-off" by the defendants, in desperation wrote to ten brokers in Great Britain only to learn that the brokers were offering approximately half the price of his initial investment per unit and that even should he be willing to sell at such a loss he probably would not be able to do so inasmuch as the brokers were only "interested in large quantities" (Tr. 444-447, 449-450).

4. Misrepresentations concerning insurance. With regard to the insurance coverage to be provided, the defendants and their agents have also misled prospective investors. Investors have been told that there are two insurance policies included in the purchase price, one insuring the investor against fraud, collusion, and forgery and the second insuring him against All Risks, Fire and Theft (Tr. 50-51, 138-139, 198, 200, 215, 218-219, 280, 387-388, 572; Exhs. 5, 7, 49, 54, 65, 69, 96). Investors are led to believe that they will be insured against any loss for approximately 110% of the value of the investment for the first year, 150% for the second and 200% for the third and fourth years (Tr. 312, 387-388, 572; Exhs. 5, 7, 49, 54, 65, 96). The defendants' statements concerning the insurance protection they offer, however, are false and misleading. They specifically fail to advise the investor that the first insurance policy allegedly covering cases resulting from fraud, collusion and forgery only affords coverage against "fraud, misappropriation, error or omission on the part of the warehousekeepers," not on the part of such other parties as brokers and retailers (Tr. 312, 387-388, 572; Exhs. 11a, 12, 12k, 32, 33, 40). They also fail to advise investors that the second insurance policy allegedly covering losses resulting from All Risks, Fire and Theft actually only covers whisky which is in existence in a bonded duty free warehouse

in the United Kingdom. Thus, the risk that the whisky may not exist is not insured against (Exhs. 11e, 12, 121, 32, 33, 38).[17/]

5. Other material misrepresentations and omissions. The defendants have omitted to inform prospective purchasers that the receipt or sale of bulk whisky in the form of the whisky investments might subject them to certain permit and tax provisions of the United States Code (Tr. 117-118, 151, 625; 26 U.S.C. 194.35, 194.52, 251.31, 5111(a), 5121(a), 5691(b); 27 U.S.C. 203(c); 27 CFR 3.10 through 3.14).

Finally, the defendant Glen-Arden and its agents have represented to prospective investors that they were not being investigated by the Commission when they knew such representation to be false (Tr. 275, 278, 306, 420-422, 577-578, 610, 626-627, 658-659, 661-663, 724-725, 779, 783, 787; Exhs. 24, 26, 27, 34, 55, 59 (pages 43-45)).

17/ In the case of warehousing charges, there is investor testimony that in at least three instances defendants failed to satisfy their obligation to pay these charges (Tr. 112-16, 282, 582-83; Exs. 16, 19, 53). One investor, Randel Hanes, testified that he received a warehouse bill for 44.06 pound sterling (Ex. 19). Hanes subsequently wrote several letters to Deeb, requesting that Glen-Arden resolve the problem and finally, in desperation, telephoned Deeb (Exs. 16, 19; Tr. 112-116). Hanes described the telephone conversation as follows:

"Q Sir, you indicated that you had a conversation with Mr. Deeb. Can you indicate what Mr. Deeb said to you?

A Mr. Deeb was very angry because I had contacted directly the warehouse in Scotland that was supposedly storing the whisky.

Q What did you say to him and what did he say to you?

A I don't remember exactly the conversation, but he indicated this was not the proper procedure for me to follow, to contact the warehouse directly. This was Milbank's prerogative, as I understood it." (Tr. 113.)

STATUTES AND RULE INVOLVED

Section 2(1) of the Securities Act of 1933, 15 U.S.C. 77b(1), provides:

> "The term 'security' means any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security,' or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing." 18/

The statutory bases of the lower court's jurisdiction and the registration requirements contained in Section 5 of the Securities Act, 15 U.S.C. 77e, and the antifraud provisions contained in Section 17(a) of that Act, 17 U.S.C. 77q(a), and in Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5 thereunder, 17 CFR 240.10b-5, are also involved in this case and are reproduced in the statutory appendix hereto.

18/ Section 3(a)(1) of the Securities Exchange Act of 1934, 15 U.S.C. 78c(a)(1), which defines the term "security" for purposes of the antifraud provisions of that Act relied upon in the Commission's complaint, is substantially identical in all relevant respects to the definition of that term contained in Section 2(1) of the Securities Act. See Tcherepnin v. Knight, 389 U.S. 332, 335-336 (1967).

ARGUMENT

I. THE DISTRICT COURT PROPERLY CONCLUDED THAT DEFENDANTS OFFERED AND SOLD SECURITIES IN VIOLATION OF THE REGISTRATION AND ANTIFRAUD PROVISIONS OF THE FEDERAL SECURITIES LAWS.

1. The Federal Securities Laws Should be Construed Broadly.

The Supreme Court has consistently stated that the federal securities laws, "enacted for the purpose of avoiding frauds," must be construed "not technically and restrictively, but flexibly to effectuate [their] remedial purposes." Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 195 (1963) (Investment Advisers Act); accord, Tcherepnin v. Knight, 389 U.S. 332, 336 (1967) (Securities Exchange Act); Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972) (Securities Exchange Act); see Securities and Exchange Commission v. C. M. Joiner Leasing Corp., 320 U.S. 344, 353-354 (1943) (Securities Act). On each occasion that the Supreme Court has considered the question whether certain interests were securities within the meaning of the federal securities laws, it has held a security to have existed and has reversed narrow interpretive decisions of the lower courts to the contrary. See Tcherepnin v. Knight, supra, 389 U.S. 332; Securities and Exchange Commission v. United Benefit Life Ins. Co., 387 U.S. 202 (1967); Securities and Exchange Commission v. Variable Annuity Life Ins. Co., 359 U.S. 65 (1959); Securities and Exchange Commission v. W. J. Howey Co., 328 U.S. 293 (1946); and Securities and Exchange Commission v. C. M. Joiner Leasing Corp., supra, 320 U.S. 344.

The broad remedial purpose of the Securities Act of 1933, 15 U.S.C. 77a, et seq., was stated in the report of the Senate Committee on Banking and Currency, S. Rep. No. 47, 73d Cong., 1st Sess. 1 (1933), at the time that Act was being considered:

> "The aim is to prevent further exploitation of the public by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities offered to the public through crooked promotion; . . . ."

Similarly, the report of the House Committee on Interstate and Foreign Commerce, H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933), noted that during the decade following the first world war:

> ". . . $25,000,000,000 worth of securities floated . . . proved to be worthless. These cold figures spell tragedy in the lives of thousands of individuals who invested their life savings, accumulated after years of effort, in these worthless securities . . . . Alluring promises of easy wealth were freely made with little or no attempt to bring to the investor's attention those facts essential to estimating the worth of any security. High-pressure salesmanship rather than careful counsel was the rule in this most dangerous of enterprises."

Thus a principal purpose of the Securities Act was to assure that "the persons . . . who sponsor the investment of other people's money should be held up to the high standards of trusteeship." H. R. Rep. No. 85, supra, at 3. And to serve that purpose, the term "security" was defined

> "in sufficiently broad and general terms so as to include within that definition the many types of instruments that in our commercial world fall within the ordinary concept of a security."

H. R. Rep. No. 85, supra, at 11.

Like the Securities Act of 1933, the Securities Exchange Act of 1934, 15 U.S.C. 78a, et seq., was enacted in response to "the speculative orgy of 1928 and 1929," S. Rep. No. 1455, 73d Cong., 2d Sess. 81 (1934), and a presidential call for securities "legislation [that] has teeth in it." H. R. Rep. No. 1383, 73d Cong., 2d Sess., 2 (1934). Necessarily, Congress recognized that "[s]peculation, manipulation, . . . investors' ignorance, and disregard of trust relationships by those whom the law should regard as fiduciaries" were "all a single seamless web," id. at 6, and the Securities Exchange Act's remedial provisions would have to be equal to the problem.[19/] "No one of these evils can be isolated for cure of itself alone," id. at 5. Thus, the Securities Exchange Act was intended to cover "a wide field." Ibid. And the Supreme Court has recognized that the Securities Exchange Act "contains a definition of security virtually identical to that contained" in the Securities Act. Tcherepnin v. Knight, supra, 389 U.S. at 335-336.

2. Defendants Have Engaged in The Offer and Sale of Securities.

In Securities and Exchange Commission v. C. M. Joiner Leasing Corp., supra, 320 U.S. 344, the landmark decision in which the Supreme

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19/ The House Committee appraised the function of the Securities Exchange Act as an undertaking to advance the law by a "constant extension of the legal conception of a fiduciary relationship--a guarantee of 'straight shooting' . . . ." H.R. Rep. No. 1383 73d Cong., 2d Sess. 5 (1934).

Court first considered the breadth of application of the federal securities laws, the Court gave determinative weight to the congressional objectives, stating, 320 U.S. at 350-351, that

> "courts will construe the details of an act in conformity with its dominating general purpose, will read text in the light of context and will interpret the text so far as the meaning of the words fairly permits so as to carry out in particular cases the generally expressed legislative policy."

The Court recognized in Joiner that in some cases proof of the existence of a security "must go outside the instrument itself," 320 U.S. at 355.

An analogy is readily apparent between the Joiner case and the case at bar. Here defendants claim to sell nothing more than naked casks of whiskey. In Joiner it was similarly claimed that there had been only "sales and assignments of legal and legitimate oil and gas leases," 320 U.S. at 348. But the Supreme Court observed, ibid., that the defendants "were not, as a practical matter, offering naked leasehold rights;" they offered purchasers an opportunity of sharing the benefits of a "current [oil] exploration enterprise," ibid. The Court, at page 348, found significant that

> "[t]he exploration enterprise was woven into . . . [the] leaseholds, in both an economic and a legal sense; the undertaking to drill a well [ran] through the whole transaction as the thread upon which everybody's beads were strung."

And it emphasized, id. at 349, the economic reality of what had been offered:

> "It is clear that an economic interest in this well-drilling undertaking was what brought into being the instruments that defendants were selling and gave to the instruments most of their value and all of their lure."

Similarly, in the case at bar, as the court below recognized (Op. p. 12),

> "[u]nquestionably, the warehouse receipts were merely a means by which the defendants transacted their business. Their true product was an investment package. Ownership, right of possession or the right to consume were in reality of little import to the purchasers of the receipts."

In Joiner there was an implicit undertaking of the defendants to drill a well from which the investors might profit. Here there is defendants' explicit undertaking as part of the investment package not only to provide expertise in selection of scotch whisky which is properly encased and which after four years of aging is guaranteed to have doubled in value, but also warehousing and insurance adequate to protect the investment and current information about the scotch whisky market and assistance in reselling at the current pricing schedule without a fee and without the investors' handling any of the paper work. Without such undertakings investors would not have purchased the package from defendants. The essential tasks to be performed by defendants, their officers and agents, like the oil exploration program in Joiner, is "the common thread upon which everybody's beads were strung." 320 U.S. at 348.

Under the Joiner decision the test to determine the existence of a security is ". . . what character the instrument is given in

commerce by the terms of the offer, the plan of distribution and the economic inducements held out to the prospect." 320 U.S. at 352-353, quoted and followed in Securities and Exchange Commission v. United Benefit Life Ins. Co., supra, 387 U.S. 211. The Court in Joiner held, 320 U.S. at 351:

> "[T]he reach of the Act does not stop with the obvious and commonplace. Novel, uncommon, or irregular devices, whatever they appear to be, are also reached if it be proved as matter of fact that they were widely offered or dealt in under terms or courses of dealing which established their character in commerce as 'investment contracts,' or as 'any interest or instrument commonly known as a "security."'"

The evidence in this case indicates that persons who are induced by defendants to purchase their casks of whisky are in reality being induced to invest in the enterprise of defendants.

Indeed, as the Court in Joiner said, id. at 553:

> "In the enforcement of an act such as this it is not inappropriate that promoters' offerings be judged as being what they were represented to be."

In Joiner, 320 U.S. at 346, "language in the advertising literature emphasized the character of the purchase as an investment and as a participation in an enterprise." Here, as we have seen (pp. 11-15, supra), defendants promoted their scheme as an investment and have so represented it to the objects of their sales efforts.

It is, of course, true that defendants have attempted to structure their operation to avoid the outward appearance of a security. But this has often occurred. In Joiner, as well as in numerous other cases, what in form appeared to be the offer and sale of interests in land, chattels or intangible property has been held to involve the offer

and sale of "investment contracts" and therefore securities.[20] There is every reason why the same principle should apply to the casks of whisky sold by defendants.

In Securities and Exchange Commission v. W. J. Howey Co., supra, 328 U.S. 293, in which interests in orange groves were held to be securities, the Supreme Court emphasized, id. at 298, the correctness of state-court decisions in which "[f]orm was disregarded for substance and emphasis was placed upon economic reality."[21] Because

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20/ See e.g., Securities and Exchange Commission v. C. M. Joiner Leasing Corp., 320 U.S. 344 (1943) (Oil leases); Securities and Exchange Commission v. W. J. Howey Co., 328 U.S. 293 (1946) (orange groves); Continental Marketing Corp. v. Securities and Exchange Commission, 387 F. 2d 466 (C.A. 10, 1967), certiorari denied, 391 U.S. 905 (1968) (live beavers); Securities and Exchange Commission v. MacElvain, 417 F. 2d 1134 (C.A. 5, 1969) certiorari denied, 397 U.S. 972 (1970) (interest in a lawsuit); Roe v. United States, 287 F. 2d 435 (C.A. 5, 1961), certiorari denied, 368 U.S. 824 (1961) (oil leases); Los Angeles Trust Deed and Mortgage Exchange v. Securities and Exchange Commission 285 F. 2d 162 (C.A. 9, 1961), certiorari denied, 366 U.S. 919 (1961). (mortgages and deeds of trust); Penfield Co. of Cal. v. Securities and Exchange Commission, 143 F. 2d 746 (C.A. 9, 1944), certiorari denied, 323 U.S. 768 (1944) (whiskey warehouse receipts); and Securities and Exchange Commission v. Crude Oil Corp. of America, 93 F. 2d 844 (C.A. 7, 1937) (crude oil).

21/ The Supreme Court in Howey noted that when Congress included the term "investment contract" in the definition of "security," it was using "a term the meaning of which had been crystallized by . . . prior judicial interpretation." 328 U.S. at 298. The Court then analyzed state judicial decisions interpreting the term "investment contract" before the enactment of the Securities Act, recognizing (328 U.S. at 298) that

> "[a]n investment contract thus came to mean a contract or scheme for 'the placing of capital or laying out of money in a way intended to secure income or profit from its employment.' State v. Gopher Tire & Rubber Co., 146 Minn. 52, 56, 177 N.W. 937, 938."

The court in Gopher Tire had observed, in terms equally applicable to the case at bar, that one of the major purposes underlying the Minnesota Blue Sky Law was to "put a stop to the sale of . . . 'get-rich-quick' schemes calculated to despoil credulous individuals of their savings." 177 N.W. at 938. In order effectively to accomplish this purpose the Minnesota court had broadly defined "investment contract," noting that a "hard and fast rule" as to what is a security must be avoided so as not "to aid the unscrupulous in circumventing the law." Ibid.

the promoters had offered common management of the real estate interests they conveyed, the Supreme Court had observed, id. at 300:

> ". . . all the elements of a profit-seeking business venture are present here. The investors provide the capital and share in the earnings and profits; the promoters manage, control and operate the enterprise. It follows that the arrangements whereby the investors' interests are made manifest involve investment contracts, regardless of the legal terminology in which such contracts are clothed."

The Court concluded, id. at 301: "The test is whether the scheme involves an investment of money in a common enterprise with profits to come solely from the efforts of others."

In Blackwell v. Bentsen, 203 F. 2d 690 (1953), reversing [1948-1952 Decisions] CCH Fed. Sec. L. Rep. ¶90,529 (S.D. Tex., 1952), certiorari denied, 347 U.S. 925 (1954), the court considered a scheme by which citrus acreage was sold along with a mangement contract. The court "notice[d] minor and non-determinative differences between the facts of . . . [that] case and those in the Howey and Joiner cases but [held] the determinative factors are in principle the same," id. at 692. One difference that was specifically noted was that "the management contract [in Blackwell] contained provisions for an investor to give direction as to the marketing of the crop of his tracts, in which event the management company would follow these directions . . . ." id. at 691-692. The court held that a security was purchased by all who accepted the management contract; it did not except purchasers who may have given directions respecting the marketing of their crops.

In Continental Marketing Corp. v Securities and Exchange Commission, 387 F. 2d 466 (C.A. 10, 1967), the court found that the sale by defendants of live beavers involved the offer and sale of an investment contract. The investors in that case were offered a package of services with the beavers although the investors were told that they could control the commodity purchased. The court in that case, in response to the argument that there was no security because the defendants and persons they controlled did not provide the services necessary before any profit could be made, said at page 470:

> "We do not think the element of ownership or control is essential. The better approach . . . is to disregard form for substance and place emphasis on economic reality. The more critical factor is the nature of the investor's participation in the enterprise. If it is one of providing capital with the hopes of a favorable return then it begins to take on the appearance of an investment contract notwithstanding the fact that there may be more than one party or other than a principal party and his agent at the other end of the transaction or transactions."

The evidence adduced by the Commission demonstrates that what defendants are selling in this case fits within those types of investment interests which have been held to be securities. The investor in whisky interests is entirely dependent for any profits on the expertise, managerial ability and continued existence of the enterprise of defendants.

Blackwell v. Bentsen, supra, 203 F. 2d 690, makes clear that the pooling of the interests of the several investors is not necessary and that the profits of one investor need not depend on those of another.

It is the dependence of the investor on the success of the overall management efforts of the promoter that is controlling. Thus, the Court of Appeals for the Ninth Circuit has held in Securities and Exchange Commission v. Glenn W. Turner Enterprises, Inc., 474 F. 2d at 482, note 7:

> "A common enterprise is one in which the fortunes of the investor are interwoven with and dependent upon the efforts and success of those seeking the investment or of third parties. See e.g., Los Angeles Trust Deed & Mortgage Exchange v. SEC, Ninth Cir., 1961, 285 F. 2d 162, 172, certiorari denied, 366 U.S. 919."

See also Securities and Exchange Commission v. Wickham, 12 F. Supp. 245 (D. Minn. 1935); Securities and Exchange Commission v. Payne, 35 F. Supp. 873 (S.D.N.Y. 1940). Two recent district court decisions recognizing that persons who are selling interests similar to those sold by defendants herein are engaged in the offer and sale of securities have awarded injunctions against further sales in violation of the registration and antifraud provisions of the Securities Act and of the Securities Exchange Act. In Securities and Exchange Commission v. M.A. Lundy Associates, CCH Fed. Sec. L. Rep. [1973 Transfer Binder] ¶94,040 (D. R.I., 1973), the court refused to accept defendants' contention similar to the one made herein that the investor merely purchased specified number of gallons of raw unblended whisky, which he was free to dispose of as he saw fit:

> "In making this contention, they ask this Court, in effect, to ignore the realities of the situation and to ignore the inducements set forth in the said MacPherson brochure." (P. 94, 186.)

The "inducements" in the MacPherson brochure referred to in the Lundy case are virtually identical to those made by defendants herein. The court after examining the appropriate authorities stated:

> "[I]t is abundantly clear that 'the nature of the investor's participation in the enterprise' is that 'of providing capital with the hopes of a favorable return.' From the evidence it is also clear that the majority, if not all, of the investors in said scotch whisky warehouse receipts is dependent upon the advice of the brokers thereof. It must be borne in mind that the purpose of their acquisition is the realization of a profit on their resale." (p. 94, 186)

The court concluded from a "realistic appraisal" of the evidence and the reasonable inferences therefrom that defendants were offering and selling securities (ibid.).

In Securities and Exchange Commission v. Haffenden-Rimar International, Inc., 362 F.Supp. 323 (E.D. Va. 1973), appeal pending, the court rejected defendants' contention that the investors purchased a specified number of gallons of raw unblended whisky to hold, consume, sell or deal with as they saw fit and found that defendants were actually selling securities:

> "Most, if not all, of the investors relied solely on the advice of the defendants in selecting, buying, storing, trading and selling the Scotch represented by their warehouse receipts and/or letters of acknowledgement - Their participation in the enterprise was limited to providing capital with the hope of a favorable return." 362 F. Supp. at 327.

Defendants have argued that the profits do not come solely from defendants' efforts but rather come from the "market" for the whisky at the time of resale (Br. 49-53). In light of the investors' testimony that they are purchasing an investment package of which the continued existence of the defendants is essential, this argument misses the point. The evidence shows that investors rely on defendants' skills and services - as defendants intend them to do - throughout. Defendants select the type of whisky to be purchased, as they also select the types of insurance, warehousing and cooperage. Defendants not only advise as to whether or not investors should hold, resell or exchange for other whisky, but have even promised to effect resales. Thus, investors look to defendants - as defendants intend them to do - to evaluate the "market." In these circumstances, it is frivolous for defendants to argue that the undefined role of the "market" saves the investment package they sell from being a security. In any event, the fact that the law of supply and demand may be instrumental in creating a profit has never been thought to negate the existence of a "security." Cf., e.g., Securities and Exchange Commission v. W. J. Howey, supra (market for oranges); Continental Marketing, Inc. v. Securities and Exchange Commission, supra, (market for beavers). See also, Securities and Exchange Commission v. Glenn W. Turner Enterprises, Inc., 474 F.2d, supra, at 482; Lin v. City Investing Co.,(1973 Transfer Binder) CCH Fed. Sec. L. Rep. ¶94, 124 (C.A.3, August 1973).

Defendants also argue that the legislative history of the term "security" demonstrates that Congress "expressly deprived the SEC of

authority to regulate or to commence action" involving documents of title to specific, identified casks of whisky in warehouses in Scotland (Br. 40-48). Defendants base their argument on the fact that the phrase "certificate of interest in property, tangible or intangible," was stricken out of the definition of "security" as possibly involving "too broad and uncertain application." H.R. Rep. No. 1838, 73d Cong., 2d Sess. p. 39 (5-31-34). Elimination of this term, however, was certainly not intended to preclude an instrument of investment from falling within the purview of the remaining terms included within the definition of "security." Thus, the Supreme Court in Tcherepnin v. Knight, 389 U.S. 332 (1967), held that a withdrawable capital share in an Illinois savings and loan association, although an "investment contract," could also be viewed as "certificate[s] of interest" or participation in any profit-sharing agreement, or as "stock" or as "transferable share[s]." See also, Securities and Exchange Commission v. C. M. Joiner Corp., 320 U.S. 344, 350-351 (1943). Indeed, defendants' argument that all the purchasers were getting was a tangible item has often been rejected. See cases cited supra p. 32.

Defendants also apparently argue that the terms "investment contract" and "interest or investment commonly known as a security" are void for vagueness (Br. 61-66). This Court has recently characterized as "untenable" that same argument as to the term "investment contract" when made by one of the corporate defendants herein. Securities and Exchange Commission v. Brigadoon Scotch Distributors, Ltd., 480 F. 2d 1047, 1052 (1973), certiorari pending, No. 73-677, and with good reason. The term "investment contract"

has been construed by the Supreme Court on five separate occasions. 22/ The Court has stated that its meaning "had been crystallized by . . . prior judicial interpretation" in the state courts before Congress included it in Section 2(1) of the Securities Act. Securities and Exchange Commission v. W. J. Howey Co., supra, 328 U. S. 298. The term "commonly known as a security" has also been construed by the Supreme Court. 23/

3. The District Court Properly Determined that Defendants Have Engaged in a Pervasive Scheme to Defraud the Public.

The entire nature of the defendants' efforts to sell their wares was calculated to defraud the investing public concerning the nature of the scotch whisky industry, the content of the investment

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22/ Tcnerepnin v. Knight, 389 U.S. 332, 338; Securities and Exchange Commission v. United Benefit Life Ins. Co., 387 U.S. 202, 211; Securities and Exchange Commission v. Variable Annuity Life Ins. Co., 359 U.S. 65, 72; Securities and Exchange Commission v. W. J. Howey Co., 328 U.S. 293; Securities and Exchange Commission v. C. M. Joiner Leasing Corp., 320 U.S. 344.

23/ Securities and Exchange Commission v. C.M. Joiner Leasing Corp., 320 U.S., supra at 351. Connally v. General Construction Co., 269 U.S. 385, and Lanzetta v. New Jersey, 306 U.S. 451, cited by petitioners (Br. 63-64) are not inconsistent. In Connally, the Court held a statute unconstitutional because the application of the statute did not depend upon a word of fixed meaning in itself or one made definite by statutory or judicial definition or by the context or other legitimate aid to its construction. In Lanzetta v. New Jersey, the Court held unconstitutional a statute which in effect made it unlawful for a person not to be engaged in "any lawful occupation" if he were a member of a "gang consisting of two or more persons" and had been previously convicted of certain offenses. The word "gang" was found to have no common law antecedent and no available definition relating to criminal activities.

package they were buying and the "guarantees" of profits. The evidence adduced by the Commission convinced the court below that the defendants were engaged in a "pervasive scheme to defraud the public." (Op. p. 14).

Investors were told that "we'd never lose anything on the investment" (Tr. 386) or "we could expect a return of a minimum of 90 to 100% of our original investment at the end of four years." (Tr. 388; see also Tr. 138, 212-13, 386, 388.) Optimistic representations as to future value, without disclosure of the underlying risks, have consistently been held to be fraudulent See Hanly v. Securities and Exchange Commission, 415 F. 2d 589, 597 (C.A. 2, 1969); James DeMammos, Securities Exchange Act Release No. 8090 at p. 3 (6/2/67), affirmed from the bench, C.A. 2, No. 31469 (10-13-67).

Concomitant with their representations as to future value, defendants guaranteed a riskless investment. They explained that as Scotch ages, it always becme more valuable, increasing in value day by day[24/] (supra, pp. 13-14). The evidence directly contradicts their representations. The evidence shows there was overproduction of grain whisky in the late 1960's and a resulting surplus which depressed the grain Scotch whisky market (supra, p. 17). Further, defendants never advised investors that the prices which the investors paid defendants were highly marked-up, and were considerably in excess of the prices charged by other brokers (supra, pp. 18-19).

24/ Investors were also told that "there is never any unsold scotch on the market" and that the "Scotch Whisky industry is unique in that it is probably the only industry which sells everything it produces" (Exh. 49 (page 2); see also Exh. 63).

Investors were led by defendants to believe that there existed a scotch whisky market equivalent to the over-the-counter market for securities not listed on an exchange where public sales could be easily and quickly effectuated and from which daily quotations could be had. The fact is that unaided resale in small lots by investors is virtually impossible and that there is no readily available current market information (pp. 21-22, supra).

Defendants also deceived investors concerning their own expertise. Glen-Arden and Milbank held themselves out as providing impartial expert guidance and consulting services to investors concerning such things as current prices, market conditions, timing of investment decisions and the type and quality of scotch investments. The true facts, however, were that neither corporate defendant provided investors with accurate market information. Many investors have not even been able to contact the companies after their initial investment much less obtain guidance (pp. 16-17, supra).

Defendants also misrepresented to investors the services they would perform. For example, defendants promised to repurchase and/or render resale assistance at no additional cost and then failed to so perform.

These are some of the fraudulent aspects of defendants' enterprise (see also pages 23 - 24 , supra). Investors in that enterprise are entitled to the full protection of the antifraud provisions of the securities laws.

4. The District Court Did Not Abuse Its Discretion in Enjoining Defendants.

This matter is before the Court on the appropriateness of a preliminary injunction issued by the court below. An enjoined party seeking to overturn that discretion has the burden of showing that the district court abused its discretion. That burden properly is a heavy one, once the Commission has made a prima facie showing of violations of the law, since "the standards of the public interest not the requirements of private litigation, measure the propriety and need for injunctive relief . . . ." Securities and Exchange Commission v. Culpepper, 270 F. 2d 241, 250 (C.A. 2, 1959) (quoting from Hecht Co. v. Bowles, 321 U.S. at 331 (1944)); accord: Securities and Exchange Commission v. Manor Nursing Centers, Inc., 458 F. 2d 1082, 1100 (C.A. 2, 1972). Defendants have not met that burden. The evidence in this case shows unequivocably that defendants are selling "securities" as that term is defined in the Securities Act and the Securities Exchange Act. The Commission has moreover shown and the court below has found substantial violations of the antifraud provisions of the federal securities laws. 25/

25/ Even a "prima facie showing of fraud" is sufficient to call into play the equitable powers of the court. Securities and Exchange Commission v. Keller Corp., 323 F. 2d 397, 403 (C.A. 7, 1963); Securities and Exchange Commission v. Bowles, 427 F. 2d 190, 197-198 (C.A. 4, 1970).

Contrary to defendants' assertions, they are not being forced out of business. They are merely being compelled to conduct their business in a lawful manner. They may register their offerings with the Commission, make full disclosure and cease their fraudulent practices. The investors upon whom defendants have preyed and continue to prey have a right to no less.

CONCLUSION

For the foregoing reasons, the preliminary injunction issued by the district court should be affirmed.

Respectfully submitted,

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Securities and Exchange Commission
Washington, D. C. 20549

STATUTORY APPENDIX

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Securities Act of 1933

Prohibitions Relating to Interstate Commerce and the Mails

SEC. 5. (a) Unless a registration statement is in effect as to a security, it shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to sell such security through the use or medium of any prospectus or otherwise; or

(2) to carry or cause to be carried through the mails or in interstate commerce, by any means or instruments of transportation, any such security for the purpose of sale or for delivery after sale.

(b) It shall be unlawful for any person, directly or indirectly—

(1) to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to carry or transmit any prospectus relating to any security with respect to which a registration statement has been filed under this title, unless such prospectus meets the requirements of section 10; or

(2) to carry or cause to be carried through the mails or in interstate commerce any such security for the purpose of sale or for delivery after sale, unless accompanied or preceded by a prospectus that meets the requirements of subsection (a) of section 10.

(c) It shall be unlawful for any person, directly or indirectly, to make use of any means or instruments of transportation or communication in interstate commerce or of the mails to offer to sell or offer to buy through the use or medium of any prospectus or otherwise any security, unless a registration statement has been filed as to such security, or while the registration statement is the subject of a refusal order or stop order or (prior to the effective date of the registration statement) any public proceeding or examination under section 8.

Fraudulent Interstate Transactions

SEC. 17. (a) It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

(1) to employ any device, scheme, or artifice to defraud, or

(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser. (footnote omitted)

Jurisdiction of Offenses and Suits

SEC. 22. (a) The district courts of the United States, the United States courts of any Territory, and the United States District Court for the District of Columbia shall have jurisdiction of offenses and violations under this title and under the rules and regulations promulgated by the Commission in respect thereto, and concurrent with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by this title. Any such suit or action may be brought in the district wherein the defendant is found or is an inhabitant or transacts business, or in the district where the offer or sale took place, if the defendant participated therein, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 128 and 240 of the Judicial Code, as amended (U. S. C., title 28, secs. 225 and 347). No case arising under this title and brought in any State court of competent jurisdiction shall be removed to any court of the United States. No costs shall be assessed for or against the Commission in any proceeding under this title brought by or against it in the Supreme Court or such other courts.

Securities Exchange Act of 1934

Section 10(b), 15 U.S.C. 78j(b)

Regulation of the Use of Manipulative and Deceptive Devices

SECTION 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Section 27, 15 U.S.C. 78aa

Jurisdiction of Offenses and Suits

SECTION 27. The district courts of the United States, the United States District Court for the District of Columbia, and the United States courts of any Territory or other place subject to the jurisdiction of the United States shall have exclusive jurisdiction of violations of this title or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this title or the rules and regulations thereunder. Any criminal proceeding may be brought in the district wherein any act or transaction constituting the violation occurred. Any suit or action to enforce any liability or duty created by this title or rules and regulations thereunder, or enjoin any violation of such title or rules and regulations, may be brought in any such district or in the district wherein the defendant is found or is an inhabitant or transacts business, and process in such cases may be served in any other district of which the defendant is an inhabitant or wherever the defendant may be found. Judgments and decrees so rendered shall be subject to review as provided in sections 128 and 240 of the Judicial Code, as amended (U.S.C., title 28, secs. 225 and 347). No costs shall be assessed for or against the Commission in any proceeding under this title brought by or against it in the Supreme Court or such other courts.

Rule 10b-5, 17 CFR 240.10b-5:

Rule 10b–5. Employment of Manipulative and Deceptive Devices

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

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